

*United States Court of Appeals
for the Second Circuit*



AMICUS BRIEF

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PPS

75-1004

United States Court of Appeals For the Second Circuit

No. 75-1004

UNITED STATES OF AMERICA,
Appellee,
against
ANTHONY M. NATELLI and JOSEPH SCANSAROLI,
Defendants-Appellants.

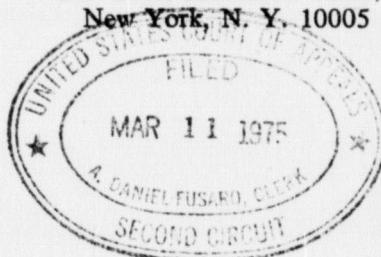
APPEAL FROM UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AS *AMICUS CURIAE* SUPPORTING REVERSAL

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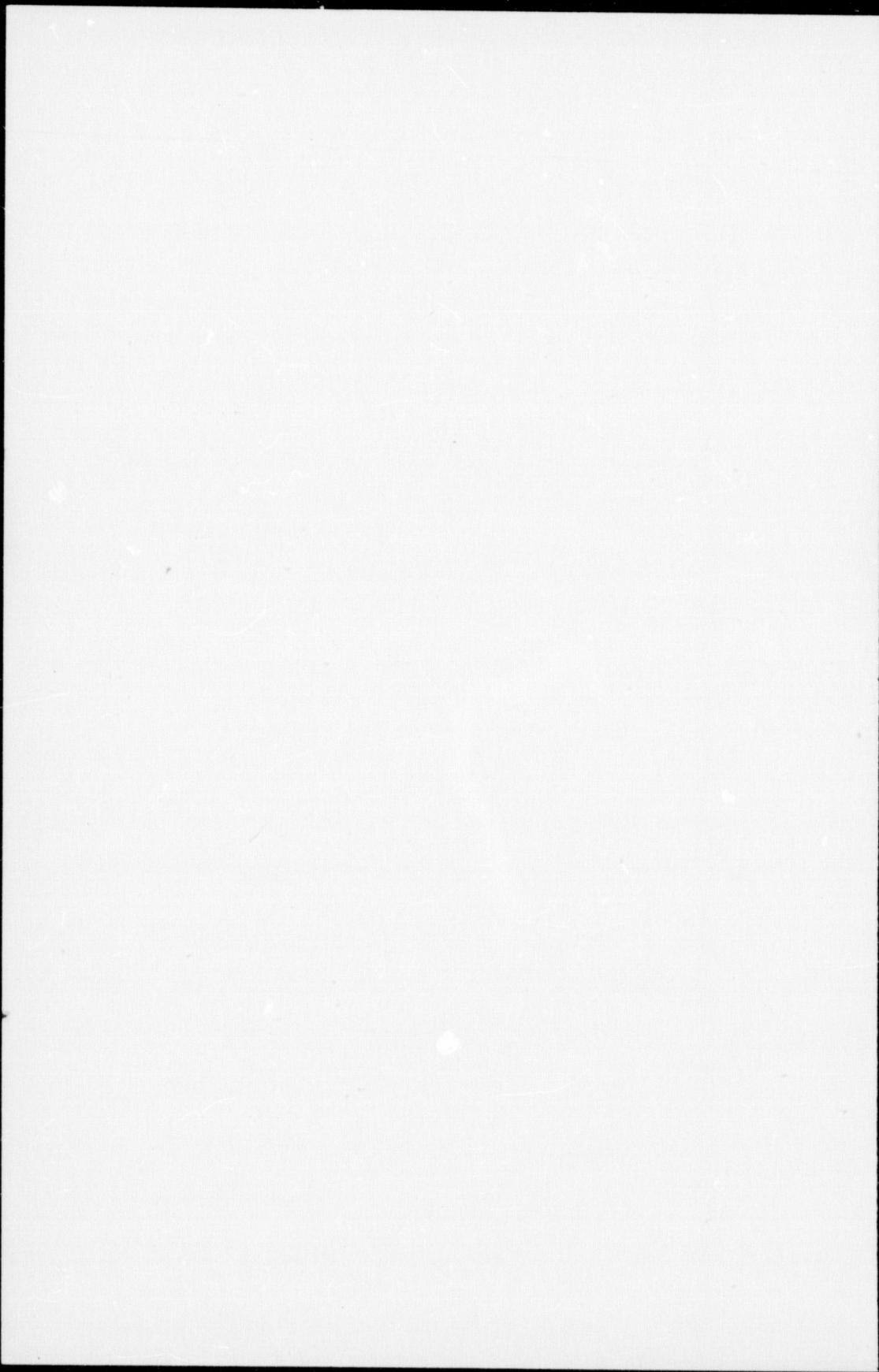
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**BRIEF FOR AMERICAN INSTITUTE OF CERTIFIED
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SUPPORTING REVERSAL**

Preliminary Statement

The American Institute of Certified Public Accountants (the "Institute") respectfully submits this brief as *amicus curiae*.

This case presents a question significant to the accounting profession generally, as well as to the individual defendants. The defendants were charged with "wilfully and knowingly" making two false and misleading statements: one in audited financial statements and the other in unaudited financial statements. Under the standards of the accounting profession, an independent accountant does not have the same responsibility with respect to un-

audited financial statements as he does with respect to audited statements. He does not have any responsibility with respect to unaudited statements unless he is "associated" with such statements by reason either of having assisted in preparing them or of their being included in a document in which his name also appears. If he is "associated" with such statements, his duty is limited to insisting upon disclosure of material departures from generally accepted accounting principles which are in fact known to him; he has no affirmative duty to satisfy himself that the statements are not misleading. The trial court did not instruct the jury on the lesser responsibilities of independent accountants with respect to unaudited financial statements and, by failing to do so, may well have led the jury to consider independent accountants to have the same responsibility for unaudited financial statements as the responsibility spelled out to the jury with regard to audited financial statements.

A decision in this case eliminating the distinction between the responsibility of independent accountants with respect to audited and unaudited financial statements would have a significant adverse impact upon such accountants, their clients and the investing public. If the distinction were eliminated, independent accountants who would otherwise be "associated" with unaudited statements would be compelled either to insist on being engaged to perform a full audit of such statements, resulting in considerable additional costs and in delays in the release of such financial statements, or else to avoid all "association" with such statements. The latter alternative would require refusing assistance in the preparation of interim financial statements and refusing to permit unaudited statements to be published in any document in which statements audited and reported on by them also appear.

Statement of the Issue

The single issue to which this brief is addressed is set forth in defendant Natelli's brief as Point II B. To emphasize the aspect of general significance which prompts the Institute's participation, the issue may be restated as follows:

May an independent accountant properly be convicted of "wilfully and knowingly" making false and misleading statements in unaudited financial statements where

(i) the accountant has not undertaken to examine as an auditor, examined as an auditor, or expressed an auditor's opinion upon the unaudited financial statements, and

(ii) the instructions to the jury allow the jury to infer the requisite knowledge of falsity if it finds that the accountant "deliberately closed his eyes to the obvious or to the facts that certainly would be observed or ascertained in the course of his accounting work" or "recklessly stated as facts matters of which he knew he was ignorant",

if the instructions do not make clear to the jury the substantial and significant difference between the professional responsibilities of the independent accountant with regard to audited financial statements and his responsibilities with regard to unaudited financial statements?

The Institute has not formulated and does not intend hereby to express a position with respect to any of the other issues presented by the appeal.

Statement of the Case

The following statement of the case highlights those matters pertinent to the single issue this brief addresses—the trial court's failure to instruct the jury as to the substantial and significant difference between the standards of responsibility of independent accountants for unaudited, as distinguished from audited, financial statements.

(a) The Indictment and Basic Charges.

Count Two of the indictment is the sole Count relevant to defendants, Anthony M. Natelli and Joseph Scansaroli, a partner and a former employee, respectively, of the national accounting firm of Peat, Marwick, Mitchell & Co. ("Peat, Marwick"). The indictment charged that defendants Natelli and Scansaroli, as independent auditors of National Student Marketing Corporation ("NSMC"), "wilfully and knowingly made and caused to be made false and misleading statements with respect to material facts . . . in a proxy statement for NSMC dated September 27, 1969" in violation of Section 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78 ff.

The proxy statement in question contained audited financial statements of NSMC for the fiscal year ended August 31, 1968, reported on by Peat, Marwick, and unaudited financial statements for the nine months ended May 31, 1969. The indictment alleged that the proxy statement was false and misleading in two respects, one related to the audited financial statements and the other related to the unaudited financial statements. The first alleged misstatement concerns footnote (D) to the audited statements for the fiscal year ended August 31, 1968. The other alleged defect—the one involved in the issue this brief addresses—relates entirely to the unaudited earnings statements for

the nine months ended May 31, 1969; the allegation is that the sales and net earnings figures in the unaudited statements were materially false and misleading.

(b) Instructions to the Jury.

The trial court's instructions to the jury set forth the four elements that the jury need find in order to convict the defendants (Tr. 2361, 2399*). This brief relates to the last of the four: the requirement that the jury find that "the defendant in question acted wilfully and knowingly". The trial court addressed itself to the meaning of "wilfully and knowingly" without making any distinction between an independent accountant's responsibility with respect to audited and unaudited financial statements. Since the jury twice asked for repetition of the instructions with regard to this element after it retired to deliberate, it is apparent that the jury considered these instructions to be crucial. Since the trial court's instructions permitted the jury to infer guilty knowledge if a defendant "deliberately closed his eyes to the obvious or to the facts that certainly would be observed or ascertained in the course of his accounting work" or if he "recklessly stated as facts matters of which he knew he was ignorant" (Tr. 2364-65), it was important that the jury be instructed as to the different responsibilities of accountants with respect to unaudited, as distinguished from audited, financial statements. Although it recognized the importance of the distinction, the trial court declined to so instruct the jury (Tr. 2384).

The trial court instructed the jury initially, and repeated the instructions twice in response to the jury's re-

* "Tr." references are to the trial transcript below.

quests after it had retired, as follows (Tr. 2363-64, 2400-01, 2426-28) :

"In the context of this case I instruct you that a defendant may be found to have acted wilfully and knowingly only if he knew that a portion of the financial statements recited in count 2, *such as the footnote or a figure entry*, was false and misleading. It is not enough, in other words merely to establish that a given defendant acted negligently or through error or mistake. Although mistakes or negligence may give rise to civil suits, they do not constitute criminal conduct." [Emphasis added.]

The references to the "footnote" and "figure entry" were, respectively, to the alleged defect in the audited statements and the alleged defect in the unaudited statements. Thus, the instructions treated both alleged misstatements together, and, unless otherwise instructed, the jury would not have any basis for perceiving that the accountants' duties with regard to the audited and unaudited statements were not governed by the same standard of investigation.*

The trial court further instructed the jury that it could find that the defendant acted "wilfully and knowingly":

"... if he deliberately closed his eyes to the obvious or to the facts that certainly would be observed or ascertained *in the course of his accounting work* or whether [sic] he recklessly stated as facts matters of which he knew he was ignorant. [Emphasis added.]

* The trial court at another point instructed the jury in a manner implying there was only one standard—an auditing standard:

"An auditor must ascertain that the financial statement in question, *such as the figures or the footnote*, fairly presents the results of operations and the financial position of the company." [Emphasis added.] (Tr. 2369)

"If you find such reckless deliberate indifference to or disregard for truth or falsity on the part of a given defendant, the law entitles you to infer therefrom that that defendant wilfully and knowingly filed or caused to be filed false financial information of a material nature with the SEC." (Tr. 2364-65)

The trial court then continued to explain to the jury the significance that might be placed upon the conformity of defendants' conduct with generally accepted auditing standards—without describing the very limited applicability of those standards to unaudited statements.

"Now, in this connection one circumstance you are certainly entitled to consider and weigh in determining whether one of the defendants acted wilfully and knowingly is whether he as an accountant followed or deviated from generally accepted auditing or accounting standards in effect at the times here pertinent." (Tr. 2365)

* * *

"Generally, as you have been told, in effect, a firm of public accountants, such as Peat, Marwick & Mitchell, engaged to perform an independent audit for a corporation such as NSMC, represents and warrants that it will perform the audit *and other accounting work* in accordance with generally accepted auditing and accounting principles, that it will render an opinion based upon its audit for example, as to whether the financial statement of the company fairly presents its financial position and the results of its business operation.

"Proof that a defendant departed from such standards of auditing and accounting *or participated in the preparation or approval of a financial state-*

ment that did not fairly present NSMC's financial position is evidence not necessarily conclusive that that defendant did not act honestly, in good faith, and that the statements contrary to such standards may have been materially false or misleading." [Emphasis added.] (Tr. 2367)

Counsel for defendants had requested that the jury be instructed as to the difference in the accountants' responsibilities with respect to audited and unaudited financial statements (see Natelli's Request No. 8) and had objected to the failure of the trial court to so instruct the jury (Tr. 2384, 2386). Although the trial court recognized the difference to be significant, it declined to instruct the jury as to the difference on the basis that its reference to the statements as being "unaudited" was itself sufficient (Tr. 2384).

The jury found the defendants guilty in a general verdict. There is no basis for determining whether the verdict resulted from a finding by the jury of a violation with regard to the audited or the unaudited financial statements; thus, the verdict may have been based entirely upon the accountants' actions with respect to the unaudited financial statements.

The importance of proper instructions as to the distinction between an independent accountant's responsibilities for audited and unaudited statements is demonstrated by the jury's concern with respect to the definition of the terms "wilfully and knowingly". Subsequent to retiring for deliberation, the jury twice requested the court to repeat the instructions with regard to the definition of those terms (Tr. 2395, 2400-01, 2426-28). The second request was made before lunch on the second day of its deliberations immediately after the jury had reported itself to be dead-

locked and the trial court had asked the jury to continue its deliberations (Tr. 2420-28). (The verdict was delivered on the afternoon of that day, Tr. 2430.) In response to the jury's second request, the trial court repeated the charge as to the sufficiency of a finding of recklessness and alluded again to its instructions as to the relevance of generally accepted auditing standards—again without making the distinction between audited and unaudited statements (Tr. 2427-28). The importance of the distinction to the jury's determinations is further emphasized by the jury's other request after it had retired. It asked to be read the testimony on the Pontiac and Eastern Airlines commitments—material going to the essence of the auditor's involvement in the unaudited financial statements (Tr. 2403).

In the process of imposing sentence on Natelli, after stating that he believed Natelli to be honest in thinking that he had done no wrong, the trial court stated:

“But the tragedy is that the jury found that this was an *audit or audits* done with reckless disregard for what was really involved.” [Emphasis supplied.]
(Sentencing Tr. 12)

Thus, the trial court clearly concluded that the jury had made its finding on the basis of defendants' reckless disregard, as opposed to direct evidence of actual knowledge, and showed its confusion as to the responsibilities of defendants with regard to the nine-months unaudited statements by concluding that the jury's finding was with regard to defendants' “audits”—whereas in fact there was but one audited statement before the jury.

ARGUMENT

The trial court committed prejudicial error in its instructions to the jury by failing to instruct it as to the distinct difference between the responsibility of an independent accountant with respect to financial statements he has audited and reported on and his very limited responsibility with respect to financial statements which he has not audited and on which he has not reported.

"Accountants should not be held to a standard higher than that recognized in their profession."—McLean, J., *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968)

The trial court's charge to the jury in this case could well have led the jury to find that the two independent public accountants were guilty of criminal conduct under the securities laws because they failed to adhere to a standard of care higher than that imposed upon their conduct by either their own profession or the courts. The trial court instructed the jury that it could infer that Natelli or Seansaroli acted "wilfully and knowingly" if it found that he "deliberately closed his eyes to the obvious or to the facts that certainly would be observed or ascertained in the course of his accounting work" or if he "recklessly stated as facts matters of which he knew he was ignorant" (Tr. 2364-65). The critical and prejudicial error in this charge is that the court completely failed, although requested, to further advise the jury that entirely different standards and responsibilities govern the work of the independent accountant "in the course of his accounting work" on un-audited, as distinguished from audited, financial statements. Without this further and most crucial explanation,

the jury could have understood (and, we submit, would naturally be led to understand) that defendants might be found to have acted "wilfully and knowingly" with regard to the falsity of NSMC's nine-months financial statements if the jury found they "certainly would [have] observed or ascertained" the falsity in the course of an *audit*. Thus the jury might have tested defendants' actions based upon what it believed defendants should have found in an audit even though defendants did not audit the nine-months statements, had no duty to audit them, and never represented to anyone that the statements were audited. Indeed, the trial court assumed that to have been the basis for the conviction (Sentencing Tr. 12).

The error of the trial court, if not corrected, thus establishes a rule of law under which an independent accountant acts at peril of criminal responsibility to the extent he does not conduct a complete audit relating to every financial statement with which he is "associated".* Such a rule is essentially unfair in its application to the defendants, who could not have been on notice of such potential criminal responsibility at the time the unaudited financial statements were filed as part of the proxy statement in 1969. Moreover, such a rule is contrary to established law and practice and would be unworkable for the accounting profession and their clients and detrimental to the investing public.

* An independent accountant will always be "associated" with unaudited financial statements included in a document filed with the SEC containing financial statements on which he has reported. AICPA, STATEMENT ON AUDITING STANDARDS No. 1—CODIFICATION OF AUDITING STANDARDS AND PROCEDURES §§ 516.03 and .12 (1972), 1 CCH AICPA Professional Standards §§ 516.03 and .12.

A. There is a clear distinction, recognized by the courts and the accounting profession alike, between an independent accountant's responsibility for financial statements which he has audited and reported on and his responsibility for unaudited financial statements as to which he has done neither.

Expressing an opinion on the fair presentation of a company's financial statements places special responsibilities upon an independent accountant. Before an independent accountant may issue such an opinion, he must satisfy himself through appropriate investigation that the presentation made in the financial statements conforms with generally accepted accounting principles, including adequate disclosure, applied on a consistent basis with prior years. AICPA, STATEMENT ON AUDITING STANDARDS ("SAS") No. 2 § 28, 1 CCH AICPA Professional Standards § 509.28. The duty of the independent accountant is to conduct this investigation according to generally accepted auditing standards. *See Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1108 (7th Cir. 1974); SAS 2 § 28. These standards are set forth in SAS 1.*

Had defendants Natelli and Scansaroli been engaged in an audit of NSMC's nine-months financial statements, the auditing standard most relevant to judging the expected scope and quality of that work in the instant case

* SAS 1 is a codification of prior AICPA Statements on Auditing Procedure ("SAP"). Prior to its adoption in 1972, and during the times relevant to the instant case, the provisions of SAS 1 cited herein appeared in SAP Nos. 33 and 38. SAS 2 § 28, cited above, was adopted in 1974 and supersedes, but does not modify the substance of, SAS 1 § 511.01. SAS 2 contains additional clarifications of SAS 1 not pertinent to the instant case.

would have been the Third Standard of Field Work, which provides:

"Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination." SAS 1 § 150.02.

General interpretations and specific procedural applications of this standard are considered in some 55 separate subsections of SAS 1.*

Thus, had defendants Natelli and Scansaroli been engaged to *audit and report on* NSMC's nine-months financial statements, these standards and procedures of SAS 1 would have provided the benchmark for determining the care to be expected of them in performing such audit. *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1107-08 (7th Cir. 1974). Defendants, however, were not engaged to audit the nine-months figures, and the nine-months statements in the proxy statement were clearly labelled as unaudited. As a result, entirely different professional standards governed the responsibilities of the independent accountants as to the NSMC nine-months statements.

An independent accountant may be "associated" with unaudited financial statements if he has prepared, or as-

* §§ 330.01-15, "Evidential Matter—Nature, Competence, Sufficiency"; §§ 331.01-16, "Evidential Matter for Receivables and Inventories"; §§ 332.01-16, "Evidential Matter for Long-Term Investments"; §§ 338.01-08, "Working Papers". Interpretations and applications of the Third Standard of Field Work were also dealt with at length in SAP's in effect during the times relevant to this case. The sections of SAS 1 cited in this footnote codify these provisions and certain additional provisions which were not in effect at those times.

sisted in the preparation of, such statements. SAS 1 § 516.03. This is an accounting, as distinguished from an auditing, service. SAS 1 § 516.01. An independent accountant may also be associated with unaudited financial statements if he has consented to the use of his name in a document, such as a document filed with the SEC, in which such unaudited statements appear. SAS 1 §§ 516.03 and .12. Thus, Peat, Marwick was "associated" with the NSMC proxy statement containing the nine-months figures.

The standards of the accounting profession, however, make clear that such "association" with unaudited statements does not result in an independent accountant having the same responsibility as he has when he expresses an opinion on financial statements. Section 516 of SAS 1 provides for very limited responsibilities of an independent accountant with respect to unaudited statements with which he is "associated", as follows:

First. The independent accountant has no duty whatsoever to audit these statements:

"The certified public accountant has no responsibility to apply any auditing procedures to unaudited financial statements." SAS 1 § 516.02.

Second. Because he has not done so, he cannot be expected to have any opinion as to the fairness of the presentation:

"Because unaudited financial statements, by definition, have not been audited by the certified public accountant, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles." SAS 1 § 516.06.

"... the statements are representations of management, and the fairness of their representation is management's responsibility." SAS 1 § 516.01.

Third. The independent accountant's *only* responsibility is to insist upon correction of departures from generally accepted accounting principles known to him:

"[I]f the certified public accountant concludes *on the basis of facts known to him* that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist . . . upon appropriate revision . . ." [Emphasis added.]
SAS 1 § 516.06; also see SAS 1 § 710.09.

Thus, when an independent accountant undertakes to audit financial statements in order to express an opinion thereon, he is charged with the responsibility of conducting that audit work according to generally accepted auditing standards. These standards require an extensive review and confirmation of a company's financial and other records. But no similar responsibilities arise from his association with unaudited statements. The standards of his profession do not impose upon him any obligation whatsoever to apply auditing procedures to those statements. His sole obligation is to insist upon disclosure of material departures from generally accepted accounting principles which in fact come to his attention.

Decisional law dealing with the responsibilities and civil liabilities of independent accountants has also recognized the distinct difference between the accountant's responsibility with respect to unaudited, as distinguished from audited, financial statements. *Fischer v. Kletz*, 266 F.Supp. 180 (S.D.N.Y. 1967); *Gold v. DCL Inc.*, 1973 CCH Fed. Sec. L. Rep. ¶ 94,036 (S.D.N.Y. 1973); *Grimm v. Whitney-Fidalgo Seafoods, Inc.*, 73 Civ. 1304 (S.D.N.Y., Dec. 4, 1973);

see *Seeburg-Commonwealth United Litigation*, 1972-73 CCH Fed. Sec. L. Rep. ¶ 93,802 (S.D.N.Y. 1972).

In *Fischer v. Kletz, supra*, and in *Gold v. DCL Inc., supra*, civil liability was claimed against independent accountants based on their failure to make certain disclosures in connection with their clients' release of interim financial reports. In *Fischer*, the independent accountant, Peat, Marwick, had been engaged to audit the annual financial report of Yale Express System ("Yale"). After completion of its audit work, Peat, Marwick was further engaged to conduct "special studies" of Yale's past and current income and expenses. In the course of the "special studies" Peat, Marwick allegedly discovered matters indicating that both the prior audited annual statements and the interim figures subsequently released by Yale during the period of the studies were substantially false and misleading. The court (Tyler, J.) held that plaintiffs had stated a cause of action to the extent they alleged Peat, Marwick failed to disclose the discovered material misstatements in the annual financial statements it had audited, but rejected plaintiffs' claim that Peat, Marwick was similarly liable with regard to Yale's unaudited interim financial reports.* Focusing on the distinction between Peat, Marwick's responsibilities on the audited annual statements and its responsibilities for the unaudited interim results, the court held:

"... issuance by Yale of the interim statements created no 'special relationship' between the investors and PMM. In respect to the interim statements, PMM was not a statutory 'independent public ac-

* The court deferred until completion of further discovery the issue of whether Peat, Marwick could be found to have actively aided and abetted Yale in the release of false interim reports by refusing to permit the use of the figures it had compiled in the place of Yale's own figures.

countant' as it was during the audit and certification of the annual report. PMM made no representations which appeared in the statements, nor did it compile the figures contained therein. In sum . . . there is absolutely no basis in law for imposing upon PMM a duty to disclose its knowledge of the falsity of the interim financial statements." *Id.* at 195.

Similarly, in *Gold* plaintiff claimed that an independent accountant, Price Waterhouse & Co., should be held civilly liable for its alleged failure to inform the investing public, at the time of a client's release of unaudited financial statements, that it proposed to qualify its opinion with respect to the client's audited figures for the year covered by the unaudited figures. Plaintiff asserted that Price Waterhouse's responsibility arose by virtue of its status as the company's independent auditor. The court, however, in dismissing the complaint against Price Waterhouse, observed the clear distinction between an independent accountant's responsibilities for audited, as distinguished from unaudited, figures. The court (Frankel, J.) agreed that a duty of disclosure arose in connection with audited figures on which an independent accountant had reported:

"The importance of the act of certifying is such that a continuing duty to disclose has been imposed where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted." 1973 CCH Fed. Sec. L. Rep. ¶ 94,036, at p. 94,168.

But, it observed:

"In the vitally different circumstances of this case, Price Waterhouse issued no public opinion, rendered no certification, and in no way invited the public to rely on its financial judgment at or around

the time in question. The earnings information of which plaintiff complains was disclosed by DCL, which specifically noted that the figures were unaudited." *Ibid.*

The court concluded:

"There is . . . no basis in principle or authority for extending an auditor's duty to disclose beyond cases where the auditor is giving or has given some representation or certification." *Ibid.*

And, considering the subsidiary issue of plaintiff's reliance, the court again stressed the difference between audited and unaudited statements:

"If an investor is sophisticated enough to care who the auditor is, he must surely care whether or not the figures he reads have been audited. He cannot acknowledge indifference to this, and then conjure up a fiction of 'reliance' on which to make the auditor bear any losses . . . he may later have realized." *Ibid.*

In *Fischer* and *Gold*, the independent accountants had not participated in the preparation of the unaudited interim statements and had not made any representations in connection therewith. The one distinction between those cases and the instant one is that in the instant case, because Peat, Marwick had reported on the NSMC statements for the year ended August 31, 1968, included in the proxy statement, it was "associated" with the NSMC unaudited statements included in the proxy statement and, therefore, had a duty to insist upon disclosure of any material misstatements in the unaudited financial statements of which it had knowledge. The distinction does not diminish the relevance of these cases; in each the court's opinion recognizes

that there is a vast difference between an independent accountant's responsibilities when he has audited and reported on financial statements and his responsibilities when he has not.

In *Grimm v. Whitney-Fidalgo Seafoods, Inc., supra*, plaintiff sought to hold an independent accountant responsible for unaudited financial statements contained in a registration statement which also contained audited statements on which the independent accountant had reported. The court, relying upon *Fischer* and *Gold*, dismissed the complaint against the independent accountant for failure to state a claim, holding that the accountant was not responsible for the unaudited statements.

The distinct significance of auditing and reporting, and the absence of responsibility to search out errors in other company statements, was referred to in *Seeburg-Commonwealth United Litigation*, 1972-73 CCH Fed. Sec. L. Rep. ¶ 93,802, at p. 93,451 (S.D.N.Y. 1972):

“Accountants have a duty to accurately and fairly review and report the financial condition of the company, but the Court does not believe that *Fischer* or any other case places a duty on them to search out and reveal errors or omissions in management's proxy material for which they have no responsibility as auditors. The Court is also of the opinion that accountants are not required to search out and report acts of mismanagement or corporate waste, except to the extent that it is revealed in the financial information certified by them. This would place the responsibility of management squarely on the accountants without the prerogatives thereof and the law is not and could not be that sweeping. Such a result would make them liable for events over which they could have no control.”

In sum, the standards of the accounting profession and courts considering independent accountants' civil liability for false and misleading statements both recognize the substantial difference between such accountant's responsibilities for financial statements he has audited and reported on and his responsibilities for financial statements he has not audited and on which he has not reported. To sanction criminal responsibility without regard to this distinction is clear error. Yet that is what the trial court did in the instant case.

B. The trial court's failure to instruct the jury as to the different standards governing an independent accountant's responsibility with respect to unaudited financial statements, as distinguished from audited financial statements, was prejudicial error.

The trial court's refusal to instruct the jury as to the different standards applicable to the independent accountant's responsibilities for audited and unaudited financial statements was prejudicial error. The instructions as given permitted the jury to find that defendants Natelli and Scansaroli acted "wilfully and knowingly" because in the course of a full audit of the nine-months statements they presumably would have discovered that they were false and misleading. The instructions permitted this finding even though Peat, Marwick did not audit those financial statements and did not indicate to anyone that it had audited those statements.

The trial court instructed the jury that it could find defendant Natelli or Scansaroli acted "wilfully and knowingly" if it found:

"... he deliberately closed his eyes to the obvious or to the facts that certainly would be observed

or ascertained in the course of his accounting work or whether he recklessly stated as facts matters of which he knew he was ignorant." (Tr. 2364-65).

This the trial court characterized as "reckless deliberate indifference" (Tr. 2365).

The instruction is based on *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied sub nom Howard v. United States*, 377 U.S. 953 (1964).* The rule stated in that case is that wilfulness may be made out "by proving that a defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant" *Id.* at 862; *see Bentel v. United States*, 13 F.2d 327, 329 (2d Cir.), *cert. denied sub nom. Amos v. United States*, 273 U.S. 713 (1926).

* The facts of the *Benjamin* case should be noted. In *Benjamin*, the accountant, Howard, became enmeshed in a stock peddling scheme involving the unregistered sale of securities of a company having no assets. Howard prepared two "Auditors Reports" for the use of certain brokers interested in the stock based on figures supplied to him by the promoter. These reports were essentially spurious. The first was prepared in two days without any examination of the books and records of the company, although the report purported to be based upon such an examination and to reflect an "accurate and true picture of the corporation's net worth". In fact it was a regurgitation of figures handed to the accountant by the principals in the fraud. The second listed substantial real estate holdings, although Howard admitted the deeds he saw did not name the company as grantee. It reported the results of various acquisitions Howard personally knew had not been made. For one of these unacquired companies, a mining firm, it showed a \$700,000 "Unrecovered Development Costs" asset, although Howard knew its principal asset, a uranium mill, had been sold in foreclosure proceedings. Although he reported hundreds of thousands in earnings, the corporation could not advance him \$200 for travel expenses and could not pay his hotel bills. These and other items, the Court concluded, were sufficient to convince the trier of fact that Howard had actual knowledge of the falsity of his reports. It added, however, that the prosecution need not have gone that far, stating the rule as quoted above.

This brief does not address itself to whether the *Benjamin* charge was appropriate in the instant case. For purposes of argument of the sole issue to which this brief is addressed, the appropriateness of the charge is assumed. Yet, having given the charge, it was incumbent upon the trial court to instruct the jury accurately as to what the accountant "had a duty to see" as regards both audited and unaudited statements.

The trial court instructed the jury as to the applicability of generally accepted auditing standards and accounting principles. (Tr. 2365-68). Because those instructions, quoted in part at pp. 7-8 *supra*, refer to such standards and principles applicable to both "audit" and to "other accounting work", and because they refer broadly to the inference permissible from departure from such standards where the accountant merely "participated in the preparation" of a financial statement (Tr. 2367), it would appear that the court intended to address these instructions to the jury's consideration of defendants' culpability on both the audited and the unaudited financial statements of NSMC. If the court did not intend the instructions to so apply, it nevertheless did not indicate that the standards applicable to unaudited and to audited statements differed. At no point during its charge to the jury did the court make clear the distinction between the audited and unaudited financial statements or otherwise refer to the limited responsibilities of an independent accountant with respect to unaudited financial statements, although defendants had requested such a charge (see Natelli's Request No. 8) and objected to the trial court's failure to so instruct the jury (Tr. 2384, 2386). Thus, the jury had no way of knowing whether the instructions were limited to an accountant's liability with respect to audited statements and could reasonably have

understood that such standards were applicable to both the audited and unaudited statements.

In determining whether a defendant had, in the words of the *Benjamin* decision, "deliberately closed his eyes to facts he had a duty to see" or, as stated by the trial court, "to the facts that certainly would be observed or ascertained in the course of his accounting work," it was obviously critical for the jury to understand the scope of the "accounting work" for which a defendant was responsible. The trial court should have made clear that the "accounting work" to which it referred would be substantially less where an audit of financial statements was not made and that, accordingly, the accountant would be much less likely to observe or ascertain in the course of his accounting work the facts he was charged to have known. Nevertheless, the jury in this case was permitted to make the *Benjamin* inference without being adequately informed concerning those very duties—the essential predicate of the *Benjamin* charge. Without an understanding of the limited responsibilities of an independent accountant with respect to unaudited statements, the jury may well have judged defendants' guilt or innocence with respect to NSMC's unaudited statements against generally accepted auditing standards governing audit work.

In sum, there is a serious possibility that defendants' conviction for having "wilfully and knowingly" filed materially false and misleading unaudited statements with the SEC rests upon the jury's finding that defendants would have discovered the falsity of those unaudited figures in the course of an audit, that they had a responsibility to conduct such an audit, and that they were therefore guilty of "reckless deliberate indifference" to truth or falsity. If allowed to stand, the court's charge, which permitted this inference, exposes independent accountants to criminal liability with respect to unaudited financial statements

with which they are "associated" unless a full audit is undertaken, regardless of the professional standards heretofore applicable with respect to unaudited financial statements.

C. The trial court's instructions, if allowed to stand, create an unworkable rule of law which will thwart the administrative and professional trend towards greater, though necessarily limited, involvement of independent accountants in unaudited financial statements.

The Institute does not suggest that independent accountants should have no responsibility with respect to unaudited financial statements with which they are "associated." On the contrary, as has been pointed out, professional standards impose upon independent accountants a duty to insist upon disclosure of material departures from generally accepted accounting principles of which they have knowledge in unaudited statements with which they are "associated." The Institute respectfully suggests, however, that the trial court's instructions in this case, if allowed to stand, would establish an unworkable rule of law. The effect of the instructions is to make an independent accountant responsible, under pain of criminal sanction and contrary to the standards of professional care applicable to auditing work, for all financial statements with which he is "associated"—including unaudited statements in a public document (such as a proxy statement) filed with the SEC which also contains statements audited by him. The result is to make the independent accountant responsible for such unaudited statements to the same extent as audited statements.

This result could have far-reaching implications. Independent accountants engaged to audit and report on year-end financial statements also are frequently asked to

advise as to or make a limited review of the client's unaudited interim financial reports. Elimination of the distinction between their responsibility for audited and unaudited statements might well cause independent accountants to insist on either auditing all statements with which they are "associated" or else avoiding all "association" with unaudited statements. If all financial statements other than annual ones were thus subject to audit, the result would be significantly to increase the expense to issuers of preparing such statements and, because of the time required to conduct an audit, greatly to delay the release of interim financial data. The alternative, and more likely, effect would be to lead independent accountants to avoid any "association" with such statements by refusing to perform any work in connection with unaudited financial statements and by refusing to allow such statements to be included in any document also containing financial statements such accountant had audited.

The significance to the investing public of any rule which would discourage involvement of independent accountants with respect to interim financial statements is emphasized by the recent trend of regulatory authorities and segments of the accounting profession to encourage greater involvement by independent accountants in interim financial reports. In Securities Act Release No. 5549, Current CCH Fed. Sec. L. Rep. ¶ 80,030 (December 19, 1974), the SEC has proposed amendments to Regulation S-X (the regulation governing the content of financial statements included in most SEC filings) to require all annual financial statements subject thereto to include a footnote containing interim financial data.* The New York Stock Exchange ("NYSE")

* The Release specifically recognizes that the proposal would involve independent public accountants in the reported interim results, but states that the SEC does not believe "that the auditor will have to audit each interim period as a separate period to fulfill his professional responsibilities".

urged, in 1973, greater involvement by independent accountants in interim financial reports.* The national accounting firm of Coopers & Lybrand, in 1974, proposed to offer to review, and provide negative assurance to the public with respect to, the quarterly financial data of clients meeting certain criteria.** The SEC, the NYSE and the Coopers & Lybrand proposals all recognize the basic distinction between independent accountants' responsibilities with regard to audited and unaudited financial statements. They recognize that clients should not bear the cost or suffer the delay that would be involved in an audit performed with regard to each quarterly statement and are careful to phrase their proposals to avoid such a result. They recognize that specific professional standards must be established to measure such accountants' responsibilities with respect to interim financial statements, which responsibilities shall be limited to the procedures and standards to be adopted.

* The NYSE stressed that such involvement "would not normally involve an audit" and should "neither relieve the corporation of responsibility for the quarterly report nor impose liability on the independent auditor". The NYSE suggested the advisability of periodic accountant-company consultations regarding accounting matters, stressing that "the matter of more formal interim reviews is an area in which there is little existing information and which would seem to merit further responsible study". The New York Stock Exchange, A White Paper, Recommendations and Comments on Financial Reporting to Shareholders and Related Matters 7 (1973).

** The proposal reviews the present responsibilities of independent accountants with respect to interim reports, as set forth above at pp. 14-15. It carefully points out that the firm does not propose to audit the interim financials and that its draft of proposed report to be issued with respect to interim financial statements will specifically point out that the review procedures followed "do not constitute an audit in accordance with generally accepted auditing standards" and therefore do not permit them to express an audit opinion. Coopers & Lybrand, The Changing Environment in Financial Reporting—Proposals for Involvement in Corporate Quarterly and Annual Reports 6-9, 21 (Preliminary Draft, 1974).

It may be that none of these three proposals will eventuate in any formal requirement of greater involvement of independent accountants with unaudited financial statements; but all three recognize the desirability of some such involvement, in the interests of both issuers and users of financial information. If a trend toward greater involvement is desirable, however, it will surely be thwarted if independent accountants must bear the same responsibility for unaudited statements as they have for audited statements. It is therefore important that this Court's decision in this criminal case make clear, as have previous decisions involving civil liability, that an accountant's responsibility for unaudited financial statements with which he is "associated" rests on professional standards which are markedly different from those governing his responsibility for audited financial statements. It will follow that, if and when specific standards with respect to work on unaudited interim statements are established as a result of present proposals, independent accountants will be judged by those standards.*

* The Auditing Standards Executive Committee of the AICPA has released certain proposed guidelines to govern an independent accountant's work on unaudited financial statements. AICPA, Guide for Engagements of Certified Public Accountants to Prepare Unaudited Financial Statements (Exposure Draft, March 1974).



CONCLUSION

For the foregoing reasons, the judgment of the District Court should be reversed and the case remanded for such further proceedings as are appropriate. We also urge the Court to make clear in its opinion the distinction between the responsibility of an independent accountant with respect to audited financial statements and unaudited financial statements.

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Respectfully submitted,

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